

mandate to slash costs and implement fiscal discipline. As one commentator put it, the assumption was that O'Neal "would be [an] effective leader[] for a new era of sobriety and careful management of risk. That era lasted for about 12 months."

30. During his first year in charge, O'Neal cut jobs and costs and cut back Merrill's fixed-income business dramatically. Critics say "O'Neal was so brutal as chief executive that Machiavelli called him cruel and Sun Tzu surrendered. But O'Neal went too far.

31. Indeed, while Merrill Lynch was cutting back, its competitors were pushing forward. Firms like Goldman Sachs and Lehman Brothers were making big profits in fixed income forcing Merrill Lynch to scramble in order to catch up.

#### **O'Neal Causes Merrill Lynch to Become the Leading Underwriter of CDOs**

32. In order to undue the damage his cost-cutting had done to Merrill Lynch's business, O'Neal caused Merrill Lynch to ramp up its investments in CDOs. When O'Neal took the reigns at Merrill Lynch, the Company was a minor player in CDOs. By the end of 2003, however, the Company had become the largest underwriter of the products in the world. It retained the lead in 2004, 2005, and 2006. CDOs are essentially mutual funds that buy securities backed by things like mortgages, auto loans and corporate bonds. Specifically, after a loan is originated, it is often packaged up into an asset-backed security. These are then sliced into different tranches and sold to institutional investors such as hedge funds and insurers. CDOs became very popular among fixed-income investors looking for higher yields in a low-yield world. In 1995, there were hardly any. In 2006, CDOs worth more than \$500 billion were issued.

33. CDOs helped fuel the housing boom of the late 1990s and most of this decade. About 40% of CDO collateral is residential-mortgage-backed securities. Almost three quarters of that is secured by risky subprime and home-equity loans.

34. When the housing bubble began to burst, rating agencies quickly began downgrading many CDOs. And while most brokerage firms began pulling back from the CDO market, Merrill Lynch did not.

35. Instead, between 2006 and mid-2007, Merrill Lynch earned over \$800 million in underwriting fees as the lead underwriter on 136 CDO deals with a dollar value of \$93 billion. And because O'Neal's compensation was tied to the Company's performance, O'Neal received a total compensation of \$48 million, \$18.5 million of which was a cash bonus, in the year 2006 alone.

36. Eager to earn his millions, O'Neal ignored the warnings of his own analysts. Indeed, in September 2006, Merrill Lynch's equity analysts warned clients that companies with subprime exposure could face lower earnings since demand for the debt could dissipate quickly as credit worsened.

37. Ironically, Merrill Lynch's analyst made his recommendation at the same time the Company was buying subprime lender First Franklin Financial Corp. for \$1.3 billion. The deal puzzled many analysts who did not understand why Merrill Lynch would be buying a subprime lender at a time when the subprime market was souring.

38. As of June 2007, Merrill Lynch was holding \$32 billion worth of hard-to-trade CDOs. Over the next few months, Merrill Lynch worked feverishly to sell down that position. Because of the credit-market meltdown, however, Merrill Lynch was able to

unload only about half of its untenable position and wound up at the end of the 2007 fiscal third quarter still holding \$15 billion in unattractive CDOs that have not been sold to investors.

### **Defendants Cause Merrill Lynch to Issue False-and-Misleading Financial Statements**

39. Between February and July 2007, the Director and Officer Defendants caused Merrill Lynch to issue at least three SEC filings painting a rosy picture of Merrill Lynch's finances. Specifically:

40. On February 26, 2007, Merrill Lynch filed its Form 10-K for fiscal 2006, which included results for the fourth quarter and full year 2006, and included the same financial results as previously reported. The Form 10-K stated in part:

During 2006, our GMI business generated record-setting financial performance by continuing to serve clients well, take measured principal risk and execute on a variety of key growth initiatives around the world. Every major GMI business produced revenue growth over 2005 against a market backdrop that was favorable for most of the year. Across all businesses, GMI had a net increase of more than 200 managing directors and directors and 280 vice presidents to its headcount.

In FICC, we continued to broaden the scope of the commodities trading business in terms of product, geography, and linkage to the broader client franchise, including trading in oil and metals and geographically in the Pacific Rim. We also enhanced our structured finance business with three strategic transactions in the U.S., United Kingdom and South Korea that we expect to provide additional sources of origination and servicing for our non-prime mortgage-backed securitization and trading platform. We also made progress in key investment areas including both interest rate and credit derivatives, principal investing/real estate, and foreign exchange.

Within FICC, on September 5, 2006, we announced an agreement to acquire the First Franklin mortgage origination franchise and related servicing platform from National City Corporation. We expect First

Franklin to accelerate our vertical integration in mortgages, adding scale to our mortgage securitization and trading platform. This acquisition was completed on December 30, 2006, the first day of our 2007 fiscal year.

In Equity Markets, we continued to enhance our leading cash equity trading platform by adding to our portfolio and electronic trading capabilities through additional investments in personnel and technology, as well as additional acquisitions, partnerships and investments. We also made progress in our equity-linked trading business, another key area of investment which increased its revenues more than 50% in 2006. Our equity financing and services business, which includes prime brokerage, set a revenue record in 2006 and continued to gain scale as we further expanded our relationships with hedge funds. The strategic risk group, our distinct proprietary trading business, also generated record revenues, benefiting from continued investments in personnel and infrastructure that provided the capabilities to take more risk when market opportunities arose. We also continued to generate increased revenues and make significant new investments in our private equity business.

41. On April 19, 2007, Merrill Lynch issued its financial results for the first quarter of 2007, in a release which stated in part:

Merrill Lynch today reported strong growth in net earnings and earnings per diluted share for the first quarter of 2007, driven by net revenues of \$9.9 billion. Net revenues were up 24 percent from the prior-year period and up 14 percent from the fourth quarter of 2006, with increases both year over year and sequentially in both Global Markets & Investment Banking (GMI) and Global Wealth Management (GWM), and in all global regions. These are the second-highest quarterly net revenues Merrill Lynch has ever generated, only \$51 million lower than in the third quarter of 2006, when net revenues included a \$2.0 billion one-time, pretax gain arising from the merger of Merrill Lynch Investment Managers (MLIM) with BlackRock, Inc. First-quarter 2007 net earnings per diluted share were \$2.26, up 414 percent from 44 cents for the first quarter of 2006, or 37 percent on an operating basis, which excludes \$1.2 billion, after taxes, of one-time compensation expenses from the 2006 first quarter. Net earnings per diluted share were down 6 percent from \$2.41 for the fourth quarter of 2006. First-quarter 2007 net earnings were \$2.2 billion, up 354 percent from the first quarter of 2006, or up 31 percent excluding the one-time

expenses in the prior-year period. Net earnings were down 8 percent from the fourth quarter of 2006, which included a lower compensation expense ratio. The pretax profit margin for the first quarter of 2007 was 31.4 percent, and the annualized return on average common equity was 23.3 percent. At the end of the first quarter, book value per share was \$41.95, up 13 percent from the end of the first quarter of 2006 and 1 percent from the end of 2006.

“This was a terrific quarter. In an environment which was volatile at times, we took full advantage of market opportunities and delivered value to our clients and our shareholders,” said Stan O’Neal, chairman and chief executive officer. “Our product capabilities and geographic reach are stronger and broader now than at any point in our history, and we continue to make investments to further enhance our franchise. We remain focused on disciplined growth to capitalize on the positive secular trends we continue to see unfold.”

#### **Business Segment Review:**

In the first quarter of 2006, Merrill Lynch recorded \$1.8 billion, before taxes (\$1.2 billion after taxes), in one-time compensation expenses. These expenses were recorded in the business segments as follows: \$1.4 billion to Global Markets & Investment Banking, \$281 million to Global Wealth Management and \$109 million to Merrill Lynch Investment Managers (which ceased to exist as a business segment upon its merger with BlackRock). Comparisons to that period in the following discussion of business segment results exclude the impact of these one-time expenses. . . .

#### **Global Markets & Investment Banking (GMI)**

GMI generated record revenues, both over all and in each of its three major business lines, for the first quarter of 2007, as the business continued to execute on targeted organic and inorganic investments for diversification and profitable growth, executed with strong operating discipline in a favorable market environment. Non-U.S. revenues, which continue to comprise more than half of GMI’s total net revenues, grew significantly faster than U.S. revenues in the period.

- GMI’s first-quarter 2007 net revenues were a record \$6.5 billion, up 43 percent from the year-ago quarter. Compared with the first quarter of 2006, net revenues increased in all three major business lines:



- Fixed Income, Currencies and Commodities (FICC) net revenues increased 36 percent to a record \$2.8 billion driven by nearly every major revenue category, as revenues from credit products, real estate, interest rate products and currencies grew to record levels. Revenues from trading commodities also increased significantly. Revenues from mortgage-related activities declined, resulting from a difficult environment for the origination, securitization and trading of non-prime mortgage loans and securities in the U.S. Revenues from activities related to U.S. non-prime mortgages, in aggregate, comprised less than 1 percent of Merrill Lynch's total net revenues over the past five quarters.
- Equity Markets net revenues increased 50 percent to a record \$2.4 billion, driven by every major business line, including a strong increase from private equity and record revenues from both the equity-linked and proprietary trading businesses.
- Investment Banking net revenues increased 47 percent to a record \$1.4 billion, as record revenues in debt origination were complemented by strong growth in revenues from both merger and acquisition advisory services and equity origination.
- Pretax earnings for GMI were \$2.3 billion, up 48 percent from the year-ago quarter, driven by the strong revenue growth. The first-quarter 2007 pretax profit margin was 35.8 percent, up from 34.7 percent in the prior-year period.

### **Global Wealth Management (GWM)**

GWM generated strong revenue and pretax earnings growth in the first quarter of 2007. The growth was driven by Global Private Client (GPC), which increased its net revenues year over year for the 10th consecutive quarter, as well as by the contribution of Global Investment Management (GIM), including earnings from Merrill Lynch's investment in BlackRock. GPC continues to focus on delivering a superior product and service offering, positioning Merrill Lynch financial advisors (FAs) as essential partners to their clients. GPC also continues to invest in technology to further enhance both the efficiency and effectiveness of the FA force, and to invest in growing the FA census globally.

- GWM's first-quarter 2007 net revenues were \$3.4 billion, up 16 percent from the first quarter of 2006:
  - GPC's net revenues increased 11 percent to \$3.1 billion, driven by every major revenue category, including record fee-based revenues, which reflected higher asset values and net flows into annuitized-revenue products. Transaction and origination revenues also increased, driven by new issue origination activity, and net interest revenues grew to a new record level.
  - GIM's net revenues increased 151 percent to \$261 million, due primarily to revenues from Merrill Lynch's investment in BlackRock, which began to contribute to revenues during the 2006 fourth quarter, as well as increases in revenues from Merrill Lynch's ownership positions in other investment management companies and the business that creates alternative investment products for GPC clients.
- Pretax earnings for GWM in the first quarter of 2007 were \$842 million, up 31 percent from the first quarter of 2006, driven by the growth in revenues. The pretax profit margin was 24.7 percent, up from 21.9 percent in the prior-year period, driven by the impact of the investment in BlackRock.
- Turnover among FAs, especially top-producing FAs, remained low. FA headcount reached 15,930 at quarter-end, as GPC continued to exercise discipline in recruiting and training high-quality FAs.
- Client assets in products that generate annuitized revenues ended the quarter at \$633 billion, up 13 percent from the first quarter of 2006, and total client assets in GWM accounts were a record \$1.6 trillion, up 10 percent. Net inflows of client assets into annuitized-revenue products were \$16 billion for the first quarter, and total net new money was \$16 billion.
- On January 29, 2007, Merrill Lynch announced that it had reached a definitive agreement to acquire First Republic Bank (NYSE: FRC), a private banking and wealth management firm focused on high-net-worth individuals and their businesses, for approximately \$1.8 billion in cash and stock.